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# Statement of the U.S. Chamber of Commerce

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**ON:**           **Hearing on Small Businesses and Tax Reform**

**TO:**           **Subcommittee on Select Revenue Measures of the Committee on  
Ways and Means**

**DATE:**       **March 3, 2011**

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The Chamber's mission is to advance human progress through an economic,  
political and social system based on individual freedom,  
incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business -- manufacturing, retailing, services, construction, wholesaling, and finance -- is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross-section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

## **INTRODUCTION**

The Chamber thanks Chairman Tiberi and Ranking Member Neal for the opportunity to comment on the impact of tax reform on small businesses. The Chamber believes that the Subcommittee should carefully consider both the importance of small businesses and the economic challenges they face as it evaluates possible changes to the federal tax code<sup>1</sup> that will foster growth, competitiveness, innovation, and job creation.

## **THE RELEVANCE OF PASS-THRU ENTITIES**

Some proponents of tax reform recently have suggested that reform be limited to corporate taxes, without consideration of the impact on those businesses that operate in pass-thru form and, thus, remit tax under the individual code. The Chamber believes this ignores a substantial number of businesses and in particular threatens to harm small businesses that are more likely to operate in pass-thru form.

According to research by the nonpartisan Tax Foundation,<sup>2</sup> roughly one-third of all business taxes are paid by owners of pass-thru businesses – the sole proprietorships, LLCs, partnerships, and S corporations that are often small in size and entrepreneurial – who report the income of these enterprises on their individual tax returns. Further, data from the National Federation of Independent Businesses indicates that 75 percent of small businesses operate as pass-thru entities. These small businesses are a critical source of job creation and innovation, creating between 60 and 80 percent of net new jobs, and employing over half the labor force.<sup>3</sup>

The past 30 years has seen a significant increase in businesses that operate in these pass-thru forms. During that time, the number of pass-thru businesses, such as sole proprietorships, S-corporations, LLCs, and partnerships nearly tripled, from 10.9 million to 30 million.<sup>4</sup> The most numerous type of pass-thrus was sole proprietorships, growing from 8.9 million to more than 23 million. S-corporations and partnerships grew the fastest, from 1.9 million to more than 7 million. As a result, more business income is now taxed under the individual income tax code than the traditional corporate code.<sup>5</sup>

This data makes clear that tax reform that addresses only the corporate tax structure would neglect a significant portion of the business community. Thus, the Chamber believes Congress must carefully consider the impact of a corporate rate reduction on these pass-thru entities and small businesses.

## **RECENT REFORM IDEAS**

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<sup>1</sup> All references to the “code” are to the Internal Revenue Code of 1986, as amended.

<sup>2</sup> See Tax Foundation, Fiscal Fact 182, The Economic Cost of High Tax Rates, available at [http://www.taxfoundation.org/research/show/24935.html#\\_ftnref5](http://www.taxfoundation.org/research/show/24935.html#_ftnref5).

<sup>3</sup> See Tax Foundation, Commentary: Small Business and the Personal Income Tax Rates, available at <http://www.taxfoundation.org/commentary/show/23860.html>.

<sup>4</sup> See Tax Foundation, News Release: Business Income to Shoulder over a Third of Tax Increase on Top Earners, available at <http://www.taxfoundation.org/news/show/26702.html>.

<sup>5</sup> See id.

## **Piecemeal Approach**

Treasury Secretary Timothy F. Geithner, at a Senate Finance Committee hearing last month stated, “You can do corporate without doing individual at the same time.”<sup>6</sup> What Secretary Geithner seems to suggest is that it is possible to reform the corporate tax code, presumably reducing certain business tax preferences to generate the revenue necessary to pay for a corporate rate reduction, while leaving individual reform or individual rate reductions for a later date.

The suggestion of undertaking corporate reform without regard for the impact of a corporate rate reduction on pass-thru entities is problematic. Preferably, the Chamber believes that Congress should pass comprehensive tax reform legislation; conversely, Congress should avoid undertaking tax reform on a piecemeal basis. Further, the Chamber believes that one specific sector, industry, or income group should not disproportionately bear the burden of paying for tax reform.

The Chamber is concerned that small businesses would disproportionately shoulder the cost of corporate tax reform if undertaken separately from individual tax reform. Under Secretary Geithner’s approach, for example, pass-thru entities presumably would lose the benefit of business tax preferences, much like those entities operating in C corporation form, but would not receive the benefit of a tax rate reduction that those operating as C corporations would receive.

## **Modified Integration Approach**

Earlier this month, Secretary Geithner posed another suggestion on how to approach reform; he suggested, at another Senate Finance Committee hearing, that Congress should consider “whether it makes sense . . . to allow certain businesses to choose whether they’re treated as corporations for tax purposes or not.”<sup>7</sup> Essentially, Secretary Geithner seemed to suggest that all entities should be taxed under the C corporation structure.

Again, the Chamber finds this approach to reform troubling. Generally, those electing treatment as a pass-thru entity do so for many reasons, both tax related and otherwise. Thus, forcing all companies to operate under the C corporation structure raises a multitude of concerns.

From a tax perspective, operating as a pass-thru entity avoids the double taxation that C corporations face – they are taxed at the corporate level on their profits and many of their shareholders pay tax again when those same earnings are distributed as dividends or when shareholders sell their stock and remit capital gains taxes; conversely, pass-thru entities pay no entity level tax and, instead, profits are reported on the individual returns of owners. This double taxation creates a bias in favor of debt financed investment rather than equity financed investment, a problem generally viewed as a serious weakness in our current tax code. Rather than fix this, the recent approach suggested by Secretary Geithner would put all businesses into this inefficient system of double taxation.

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<sup>6</sup> See Schatz, “Small-Business Status Complicates Tax Rewrite Talks,” *Congressional Quarterly* (Feb. 16, 2011).

<sup>7</sup> See “Pass-Throughs Dominate Tax Reform Conversation,” *Journal of Accountancy* (Mar. 4, 2011).

This proposal also fails to recognize that taxpayers choose to operate as pass-thru entities for a variety of non-tax reasons. Pass-thru entities provide flexibility that the C corporation structure does not allow. For example, partnerships can have one partner put in cash, another put in property, and another expertise. They can then set up their own agreement for how the profits will be divvied up; a C corporation structure does not have that flexibility.

Simplicity is another non-tax reason taxpayers choose a pass-thru entity form. To form a partnership all that is needed is two people with a profit motive and an agreement. Conversely, with a C corporation a taxpayer has to file articles of incorporation, elect a board of directors, have regular shareholder and director meetings, etc. Further, pass-thru entities make it easier to plan for business succession and ease estate tax planning concerns.

Accordingly, because of the many tax and non-tax factors which influence a taxpayer's choice of entity, the Chamber has serious concerns about the plan suggested by Secretary Geithner that would force all businesses into a C corporation structure.

## **CONCLUSION**

The Chamber thanks the Subcommittee for the opportunity to comment on the impact of tax reform on pass-thru entities and small businesses. The Chamber believes that as the Subcommittee considers fundamental tax reform, both the importance of and challenges facing these entities must be given the utmost consideration to ensure changes to the tax code allow these businesses the opportunity to grow, compete, and innovate. We look forward to working with the Subcommittee on this vital issue.